

## Do Dividends Really Matter?

The Dividend Irrelevance Theory, postulated by Modigliani and Miller, suggests that a shareholder's value is not affected by a company's dividend policy. The rationale behind this being, investors can create their own dividends by selling shares if they needed income. However, this theory can only hold if the following three factors exist: (1) no taxes on dividends and capital gains, thus the choice between the two is immaterial; (2) there is perfect information and stock prices reflect all available and relevant information, and (3) there are no agency costs between managers and shareholders.

Using the assumptions above, let's say we have a Company X, which is valued at \$10,000 and has an outstanding share capital of 1,000 shares. Then the market value of each share, in an efficient market with perfect information, would be \$10.00. Now let's, say Company X pays a dividend of \$2.00 per share; then the cash outflow of \$2,000 would mean that the value of the firm is now \$8,000 (\$10,000-\$2,000) and as such the market value of the share would fall to \$8.00 per share. After the dividend is paid the shareholder's total value is \$10.00 (\$2.00 dividend + \$8.00 market value). Now, let's say that the same Company X pays a dividend of \$5.00, then the cash outflow would be \$5,000 and the value of the firm would fall to \$5,000 (\$10,000-\$5,000). The share price would reflect this new value and would be \$5.00 per share (\$5,000 / 1,000). The total value per share, after the dividend payment would be the value of the dividend paid (\$5.00) plus the market value of the share (\$5.00), which is the same \$10.00.

Thus, regardless of a 20% payout or a 50% payout, the shareholder's value remains the same. Using the same \$10.00 per share value as above, if an investor had 100 shares in Company X, and they received a dividend of \$5.00, they would have \$500 cash in hand and \$500 in equity. If this same investor needed \$500 cash, and the Company did not pay a dividend, they could simply sell 50 shares and they would be left in the same position as if the company had paid a dividend. As stated previously, this example would only hold in a situation where there are no taxes, perfect information and no agency costs.

In reality however, there is no market or country which operates within the three parameters posed by the Dividend Irrelevance Model. Indeed, there are some markets which may meet at least one of the criteria but there is no market which meets all. For instance in Trinidad and Tobago, there is no taxation on dividends and capital gains for local investors and as such the choice between the two is immaterial. In more developed countries such as the United States, markets are very efficient and stock prices tend to reflect almost perfect information. However, only in a perfect world, would there be perfect information and the absence of agency costs.

Agency costs are the costs incurred by the owners or shareholders of a company to ensure that the management is acting in the shareholders best interest and not their own. The principals of a firm, that is, the shareholders, use their agents or managers to direct the firm in a profit-building manner, for the best interest of the shareholders. However, agents may have their own idea of how the firm should be managed, which differs from that of the owners. This is known as the Principal-Agent Concept. The assumption

around this concept is that shareholders have to employ methods to ensure that their managers are operating in such a way that is in their best interests. These methods used to monitor the managers are costly and are known as agency costs. In fact, Dividends can actually help this problem of agency costs, such that, by paying a dividend to shareholders, management is not left with excess cash and would not be tempted to spend excessively. For instance, companies who keep more cash in hand may end up paying excessive executive compensation, over paying for acquisitions and even using funds in value decreasing activities, such as, chartering private jets, paying for unnecessary and extravagant corporate retreats and so on. Thus, dividend payments can assure shareholders that the company does not have too much cash available for wasteful activities.

Additionally, information available to shareholders is usually minimal and changes in dividend policy can actually provide insight into a company's future prospects. For instance, an increase in dividend payout can signal to shareholders that the company expects to maintain or even increase its earnings in the future. However, it can also be that this company has grown to full capacity and there is no reason to re-invest earnings and as such the company passes the profits on to the shareholders. Another example where a change in dividend policy may be a signal to investors would be, a dividend cut for a company who usually pays consistently rising dividends. This could signal that the company is in trouble or it could simply mean that funds are needed for a project. Thus, as can be seen from these scenarios, nothing is ever as clear cut as the Dividend Irrelevance Theory.

Furthermore, the share price of a company does not only reflect present cash flows but also includes a non-intrinsic value, which reflects shareholders perception of the firm's future earnings. Additionally, a share may actually be undervalued, because management may have insider information which is not publicized and therefore cannot be reflected in the share price. As such, a shareholder who creates a "homemade dividend" may in fact be selling his/her self short, because they would be selling the share for much less than it is really worth and receiving a dividend from the company would be the better bet!

Suffice to say, the Modigliani-Miller Dividend Irrelevance Theory is unrealistic and static in its assumptions. In the real world- there is taxation, information is never perfect and agency costs always exist, no matter how small. Thus, in reality, a shareholder's value is indeed affected by the dividend policy of a company. Whether it is a matter of signaling fundamentals, keeping management in check or simply providing current income-the bottom line is that dividends do matter!!!